Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs, State of California

Financial Statements for the Years Ended June 30, 2006 and 2005, and Independent Auditors' Report

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS

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Deloitte & Touche LLP
2868 Prospect Park Drive
Suite 400
Rancho Cordova, CA 95670-6065
USA

Tel: +1 916 288 3100
Fax: +1 916 288 3131
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

California Veterans Board
State of California
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is administered by the Department of Veterans Affairs of the State of California (the "Department") as of June 30, 2006 and 2005, and the related statements of revenues, expenses and changes in fund equity and of cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Fund, and are not intended to present the financial position of the Department or the results of its operations and cash flows of its proprietary funds.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis on pages 2 through 8 is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

Deloitte + Touche LLP

October 10, 2006

VETERANS FARM AND HOME BUILDING FUND OF 1943

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

Introduction – The Department of Veterans Affairs

The Department of Veterans Affairs (the "Department") began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature of the Veterans Farm and Home Purchase Act of 1921 (the "Cal-Vet Farm and Home Program" or the "Program"). In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 which modified the Program to meet new needs of California's veterans. The 1943 Act established the 1943 Fund in the State Treasury and the Department established the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is the principal fund utilized for the Cal-Vet Farm and Home Loan Program. Financing is provided as installment loans, which are referred to as Contracts of Purchase.

The sales of the Fund's Home Purchase Revenue Bonds and Veterans General Obligations Bonds combined with monies received from prepayments of Contracts of Purchase and other revenues under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs have financed the purchase of farms and homes since the Program's inception. Expenditures are primarily for debt service and administration of the Program.

Fiscal Year 2006 Compared to Fiscal Year 2005

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2006 and June 30, 2005 (dollars in thousands) and the percentage change.

	2006	2005	Change	% Change
ASSETS				
Cash and investments	$ 573,053	$ 660,349	$ (87,296)	(13.2)%
Receivables under contracts of purchase—net	1,503,802	1,477,228	26,574	1.8 %
Other receivables and assets	55,785	53,855	1,930	3.6 %
TOTAL ASSETS	$ 2,132,640	$ 2,191,432	$ (58,792)	(2.7)%
LIABILITIES AND FUND EQUITY				
Liabilities:				
Bonds payable	$ 1,868,478	$ 1,913,776	$ (45,298)	(2.4)%
Other payables and liabilities	40,859	47,824	(6,965)	(14.6)%
Total liabilities	1,909,337	1,961,600	(52,263)	(2.7)%
Fund Equity	223,303	229,832	(6,529)	(2.8)%
TOTAL LIABILITIES AND FUND EQUITY	$ 2,132,640	$ 2,191,432	$ (58,792)	(2.7)%

Assets

Total assets decreased $58.8 million from $2.19 billion at June 30, 2005 to $2.13 billion at June 30, 2006. This decrease consisted primarily of the following items:

Total cash and investments decreased $87.3 million from $660.3 million at June 30, 2005 to $573 million at June 30, 2006. The decrease is the direct result of an increase in the loan portfolio and the reduction of outstanding bonds, primarily through scheduled maturities and mandatory redemptions of bonds.

Net receivables under contracts of purchase increased $26.6 million from $1.48 billion at June 30, 2005 to $1.50 billion at June 30, 2006. The change was due to rising interest rates in the housing market, which made the Program's loans more attractive to veterans, causing an increase in loan originations and reduced prepayments, while high property values in California resulted in larger individual loans.

All other receivables and assets increased by $1.9 million from $53.9 million at June 30, 2005 to $55.8 million at June 30, 2006. This is due primarily to a $1.8 million deposit to the Architecture Revolving Fund for the headquarters building heating and cooling project.

Liabilities and Fund Equity

Bonds payable and other payables and liabilities decreased $52.3 million from $1.96 billion at June 30, 2005 to $1.91 billion at June 30, 2006. This net decrease is primarily the result of scheduled maturities and mandatory redemptions not replaced by commercial paper.

Fund equity decreased by $6.5 million from $229.8 million at June 30, 2005 to $223.3 million at June 30, 2006, which represents an $8.8 million excess of expenses over revenue for the fiscal year period, offset by a $2.3 million transfer from the Disaster Indemnity Fund (Note 12).

The total asset to liability ratio for the Fund remained unchanged at 1.12 as of June 30, 2006 and June 30, 2005.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2006 and June 30, 2005 (dollars in thousands) and the percentage change.

	2006	2005	Change	% Change
PROGRAM OPERATIONS:				
Interest revenues:				
Contracts of purchase	$ 84,527	$ 90,794	$ (6,267)	(6.9)%
Investments and other	29,921	21,254	8,667	40.8 %
Total program operating revenues	114,448	112,048	2,400	2.1 %
Expenses:				
Interest expense	111,434	114,030	(2,596)	(2.3)%
Loan reserve change	(450)	(416)	(34)	8.2 %
Total program operating expenses	110,984	113,614	(2,630)	(2.3)%
Excess of program operations expenses over program operations revenues	3,464	(1,566)	5,030	(321.2)%
PROGRAM ADMINISTRATION:				
Total program administration revenues	8,133	5,791	2,342	40.4 %
Total program administration expenses	20,630	24,395	(3,765)	(15.4)%
Excess of program operations expenses over program operations revenues	(12,497)	(18,604)	6,107	(32.8)%
Gain on sale of repossessed property	204	673	(469)	(69.7)%
Excess of expenses over revenues	$ (8,829)	$ (19,497)	$ 10,668	(54.7)%

Program Operations

Interest revenue from contracts of purchase decreased by $6.3 million from $90.8 million for the year ended June 30, 2005 to $84.5 million for the year ended June 30, 2006, primarily due to the replacement of higher rate contracts during the year with new contracts at lower rates.

Interest revenues on investments increased by $8.6 million from $21.3 million for the year ended June 30, 2005 to $29.9 million for the year ended June 30, 2006. This increase is due to the SMIF quarterly interest rate increasing over the fiscal year from 2.85% at June 30, 2005 to 4.53% at June 30, 2006.

Interest expense decreased by $2.6 million from $114 million for the year ended June 30, 2005 to $111.4 million for the year ended June 30, 2006. The decrease is due to a reduction in bonds outstanding, combined with the savings achieved by the refunding of outstanding bonds to lower interest rates near the end of the year ended June 30, 2005.

Program operation revenues for the fiscal year ended June 30, 2006 are in excess of program operations expenses by $3.5 million compared to a deficiency of $1.6 million for the year ended June 30, 2005. This program improvement is due to increased investment earnings and lower debt interest expense.

Program Administration

Program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance, other miscellaneous fees collected from program participants, rental income, and certain reimbursements of prior expenses, among others. Revenues increased by $2.3 million from $5.8 million for the year ended June 30, 2005 to $8.1 million for the year ended June 30, 2006. The increase is primarily the result of an increase in fire and hazard insurance revenue due to a program-wide adjustment to property replacement values.

Total program administration expenses decreased by $3.8 million from $24.4 million for the year ended June 30, 2005 to $20.6 million for the year ended June 30, 2006. The decrease is due to a reduction of payroll and other support expenditures as well as a reduction in the reserve requirement for the self-insured life and disability program.

Gain on Sale of Repossessed Properties decreased $.5 million from the last fiscal year. This decrease is due to reduced sales of repossessed properties as the Department's holdings of these properties went from $2.5 million as of June 30, 2005 to $1.2 million as of June 30, 2006.

Economic Factors Facing Veterans Farm & Home Building Fund of 1943

At June 30, 2006, the Program's loan portfolio balance was at approximately $1.5 billion, an increase of $26.6 million, or 1.8%, from $1.48 billion at June 30, 2005. During the fiscal year, Cash and Investment balance decreased $87.3 million, or 13.22%, from a balance of $660.3 million to $573 million. Much of the decrease in Cash and Investment balance was used to retire bonds prior to scheduled maturities. Bonds payable decreased $45.3 million, or 2.37%, from $1.914 billion at June 30, 2005 to $1.868 billion at June 30, 2006. Bond ratings for the Department's GO bonds are AA-, A1 and A+ by rating agencies Standard & Poor's, Moody's and Fitch, respectively. Bond ratings for the Department's Revenue bonds are AA-, Aa2 and AA- by Standard & Poor's, Moody's and Fitch, respectively.

Fiscal Year 2005 Compared to Fiscal Year 2004

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2005 and June 30, 2004 (dollars in thousands) and the percentage change.

	2005	2004	Change	% Change
ASSETS				
Cash and investments	$ 660,349	$ 753,782	$ (93,433)	(12.4)%
Receivables under contracts of purchase—net	1,477,228	1,527,950	(50,722)	(3.3)%
Other receivables and assets	53,855	60,656	(6,801)	(11.2)%
TOTAL ASSETS	$ 2,191,432	$ 2,342,388	$ (150,956)	(6.4)%
LIABILITIES AND FUND EQUITY				
Liabilities:				
Bonds payable	$ 1,913,776	$ 2,039,554	$ (125,778)	(6.2)%
Other payables and liabilities	47,824	53,505	(5,681)	(10.6)%
Total liabilities	1,961,600	2,093,059	(131,459)	(6.3)%
Fund Equity	229,832	249,329	(19,497)	(7.8)%
TOTAL LIABILITIES AND FUND EQUITY	$ 2,191,432	$ 2,342,388	$ (150,956)	(6.4)%

Assets

Total assets decreased $151 million from $2.34 billion at June 30, 2004 to $2.19 billion at June 30, 2005. This decrease consisted primarily of the following items:

Total cash and investments decreased $93 million from $754 million at June 30, 2004 to $660 million at June 30, 2005. This decrease was the direct result of the Department using excess cash to redeem bonds.

Net receivables under contracts of sale decreased $50.7 million from $1.53 billion at June 30, 2004 to $1.48 billion at June 30, 2005. This decrease was principally the result of the current low interest rate environment. During the fiscal year, many contract holders refinanced their loans to lower interest rates with other financial institutions.

All other receivables and assets decreased $6.8 million from $60.7 million at June 30, 2004 to $53.9 million at June 30, 2005. This net decrease was primarily due to a reduction in the inventory of repossessed properties, a decrease in interest receivables brought about by the increased prepayments of higher yielding Contracts of Sale rates into lower yielding investments and a one-time receipt of $6.4 million from the Life and Disability Program for the prior fiscal year. Without the one time receipt for the prior fiscal year, all other assets decreased $364 thousand over the prior fiscal year.

Liabilities and Fund Equity

Bonds payable and other payables and liabilities decreased $131.5 million from $2.09 billion at June 30, 2004 to $1.96 billion at June 30, 2005. This net decrease was primarily the result of the early redemption of bonds using excess cash.

Fund equity decreased by $19.4 million from $249.3 million at June 30, 2004 to $229.9 million at June 30, 2005 as a result of the excess of expenses over revenues of $19.4 million.

The total asset to liability ratio for the Fund remained unchanged at 1.12 as of June 30, 2005 and June 30, 2004.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2005 and June 30, 2004 (dollars in thousands) and the percentage change.

	2005	2004	Change	% Change
PROGRAM OPERATIONS:				
Interest revenues:				
Contracts of purchase	$ 90,794	$ 100,676	$ (9,882)	(9.8)%
Investments and other	21,254	25,837	(4,583)	(17.7)%
Total program operating revenues	112,048	126,513	(14,465)	(11.4)%
Expenses:				
Interest expense	114,030	145,046	(31,016)	(21.4)%
Loan reserve change	(416)	(1,993)	1,577	(79.1)%
Total program operating expenses	113,614	143,053	(29,439)	(20.6)%
Excess of program operations expenses over program operations revenues	(1,566)	(16,540)	14,974	(90.5)%
PROGRAM ADMINISTRATION:				
Total program administration revenues	5,791	7,138	(1,347)	(18.9)%
Total program administration expenses	24,395	20,715	3,680	17.8 %
Excess of program operations expenses over program operations revenues	(18,604)	(13,577)	(5,027)	37.0 %
Gain on sale of repossessed property	673	1,173	(500)	(42.6)%
Excess of expenses over revenues	$ (19,497)	$ (28,944)	$ 9,447	(32.6)%

Program Operations

Interest revenue from contracts of purchase decreased by $9.9 million from $100.7 million for the year ended June 30, 2004 to $90.8 million for the year ended June 30, 2005, principally due to the decline of the Program's loan portfolio.

Interest revenues on investments decreased by $4.6 million from $25.8 million for the year ended June 30, 2004 to $21.2 million for the year ended June 30, 2005. This decrease was due to the current historically low interest rates of the State's Surplus Money Investment Fund, in which a majority of the program's cash is invested. Additionally, cash and investment balances decreased due to early redemption of bonds.

Interest expense decreased by $31 million from $145 million for the year ended June 30, 2004 to $114 million for the year ended June 30, 2005. The decrease was due to the significant reduction of outstanding bonds as a result of early redemptions. In addition, the Department economically refunded $144 million of bonds that resulted in debt service savings.

Net program operation results for fiscal year 2005 improved by $15 million from a deficiency of $16.5 million to a deficiency of $1.5 million in fiscal years 2004 and 2005, respectively. The improvement was mainly due to reduced interest expenses and improved investment results.

Program Administration

Program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance, other miscellaneous fees collected from program participants, rental income, and certain reimbursements of prior expenses, among others. Revenues decreased by $1.3 million from $7.1 million for the year ended June 30, 2004 to $5.8 million for the year ended June 30, 2005. The decrease was mainly the result of fewer fees collected from a lower volume of loan originations.

Total program administration expenses increased $3.7 million from $20.7 million for the year ended June 30, 2004 to $24.4 million for the year ended June 30, 2005. The increase was due to three factors: (1) Payroll and related expenses decreased by $0.5 million as the Department cut staff levels, (2) General and administrative expenses decreased by $0.8 million as many of the Department's cost control measures took effect and (3) The Self-Insured Life and Disability program contributed a $5 million expense increase between the two fiscal years. The program produced a loss of $0.8 million for fiscal year 2005 as compared to a profit of $4.2 million for the prior fiscal year.

Gain on Sale of Repossessed Properties decreased $0.5 million from the last fiscal year. This decrease was due to reduced sales of repossessed properties as the Department's holdings of these properties went from $2.5 million as of June 30, 2004 to $2.0 million as of June 30, 2005.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

BALANCE SHEETS
JUNE 30, 2006 AND 2005 (in thousands)

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents:		
Cash In State Treasury	$ 9,333	$ 11,395
State of California's Surplus Money Investment Fund	437,041	526,651
Total cash and cash equivalents	446,374	538,046
Receivables under contracts of purchase—net of allowance for uncollectible contracts of $8,050 in 2006 and $8,300 in 2005	1,503,803	1,477,228
Interest receivables:		
Contracts of purchase	6,664	7,046
State of California's Surplus Money Investment Fund	5,371	3,472
Other investments	551	527
Total interest receivables	12,586	11,045
Total current assets	1,962,763	2,026,319
NONCURRENT ASSETS:		
Investments:		
Guaranteed investment contracts	120,356	116,253
Insurance administrators	6,324	6,050
Total investments	126,680	122,303
Due from Veterans Debenture Revenue Fund	37,765	37,510
Other real estate owned, net of allowance for losses of $151 in 2006 and $351 in 2005	1,047	1,999
Land, improvements and equipment—net of accumulated depreciation of $14,421 in 2006 and $13,613 in 200	1,720	2,497
Other	2,665	804
Total noncurrent assets	169,877	165,113
TOTAL	$2,132,640	$2,191,432
LIABILITIES AND FUND EQUITY		
CURRENT LIABILITIES:		
Bonds payable—current portion	$ 139,555	$ 79,660
Accrued interest and other liabilities	25,655	30,739
Due to other funds	1,196	494
Total current liabilities	166,406	110,893
NONCURRENT LIABILITIES:		
Bonds payable—noncurrent portion	1,728,923	1,834,116
Insurance claims payable and loss reserves	14,008	16,591
Total noncurrent liabilities	1,742,931	1,850,707
Total liabilities	1,909,337	1,961,600
FUND EQUITY—Unrestricted	223,303	229,832
TOTAL	$2,132,640	$2,191,432

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands)

	2006	2005
PROGRAM OPERATIONS:		
Interest revenues:		
Contracts of purchase of properties	$ 84,527	$ 90,794
Investments and other	27,900	19,220
Transfers of revenue from Veterans Debenture Revenue Fund	2,021	2,034
Total program operations revenues	114,448	112,048
Expenses:		
Interest expense	111,434	114,030
Reversal of allowance for uncollectible contracts	(450)	(416)
Total program operations expenses	110,984	113,614
Excess of program operations expenses under (over) program operations revenue	3,464	(1,566)
PROGRAM ADMINISTRATION:		
Revenues:		
Loan fees	3,266	3,957
Other income	2,546	1,625
Net revenue—Fire and hazard insurance program	2,321	209
Total program administration revenues	8,133	5,791
Expenses:		
Payroll and related costs	10,985	12,500
General and administrative expenses	10,340	11,014
Net (revenue) expense—Self-insured life and disability insurance program	(695)	881
Total program administration expenses	20,630	24,395
Excess of program administration expenses over program administration revenues	(12,497)	(18,604)
NONOPERATING REVENUE—Gain on sale of repossessed property	204	673
Excess of revenues over expenses	(8,829)	(19,497)
TRANSFER FROM VETERANS INDEMNITY FUND (Note 12)	2,300	-
FUND EQUITY:		
Beginning of year	229,832	249,329
End of year	$ 223,303	$ 229,832

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from contractholders	$ 11,229	$ 10,986
Interest received	110,886	111,507
Interest payments	(112,750)	(113,440)
Payments to suppliers and employees	(32,293)	(27,222)
Other receipts (payments)	6,333	(1,003)
Net cash used for operating activities	(16,595)	(19,172)
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from sales of bonds	56,050	162,600
Maturities of bonds payable	(79,660)	(79,285)
Early redemption of bonds payable	(22,780)	(208,560)
Net (increase) decrease in Due from Veterans Debenture Revenue Fund	(255)	22
Net cash used for noncapital financing activities	(46,645)	(125,223)
CASH FLOWS PROVIDED BY RELATED FINANCING ACTIVITIES—Transfer from Disaster Indemnity Fund (Note 12)	2,300	-
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net (increase) decrease in receivables under contracts of purchase	(26,325)	50,962
Net (increase) decrease in investment securities	(4,377)	39,437
Purchase of land, improvements and equipment	(30)	-
Net cash (used in) provided by investing activities	(30,732)	90,399
DECREASE IN CASH IN STATE TREASURY	(91,672)	(53,996)
CASH IN STATE TREASURY:		
Beginning of year	538,046	592,042
End of year	$ 446,374	$ 538,046
RECONCILIATION OF OPERATING INCOME TO NET CASH USED FOR OPERATING ACTIVITIES:		
Deficiency of revenues under expenses	$ (8,829)	$ (19,497)
Adjustments to reconcile to net cash used by operating activities:		
Bond amortization	1,092	(533)
Reversal of allowance for uncollectible contracts	(450)	(416)
Depreciation	807	901
Gain on sale of repossessed property	(204)	(673)
Effect of changes in assets and liabilities:	-	
Increase in interest receivable—State of California's Surplus Money Investment Fund	- (1,899)	(1,200)
(Increase) decrease in interest receivable—other investments	(24)	259
Decrease in interest receivable—contracts of purchase	382	400
Decrease in other real estate owned	1,356	1,310
Decrease (increase) in other assets	(1,861)	5,958
Decrease in accrued interest and other liabilities	(5,084)	(2,470)
(Decrease) increase in due to other funds	702	(353)
Decrease in insurance claims payable and loss reserves	(2,583)	(2,858)
NET CASH USED FOR OPERATING ACTIVITIES	$ (16,595)	$ (19,172)

See notes to financial statements.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Description—The California Department of Veterans Affairs (the "Department") is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the "Board") has policy oversight of the operations of the Department, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the "Fund") was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenses are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

Basis of Accounting—The Fund has been classified as a proprietary fund for accounting purposes. Revenues are recorded when earned and expenses are recognized as incurred.

Accounting and Reporting Standards—The Fund follows the *Standards of Governmental Accounting and Financial Reporting*, as promulgated by *the Governmental Accounting Standards Board* ("GASB"). The Fund has adopted the option under Governmental Accounting Standards Board Statement No. 20 (GASB No. 20), *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Funds Accounting*, which allows the Fund to apply all GASB pronouncements and only *Financial Accounting Standards Board* ("FASB") pronouncements which date prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board ("FASB") Statements and Interpretations, Accounting Principles Board ("APB") Opinions, and Accounting Research Bulletins ("ARBs") of the Committee on Accounting Procedures.

Use of Estimates in the Preparation of Financial Statements—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Investments—The Department reports all investments at fair value except for certain nonparticipating fixed interest investment contracts which are valued using cost based measures. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund (“SMIF”). Uncommitted bond proceeds for loans to veterans are reflected in the balance sheet within the investments balance.

Receivables under Contracts of Purchase—Receivables under contracts of purchase consist of the remaining contract principal balance net of the reserve for uncollectible accounts.

Allowance for Uncollectible Contracts—The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers’ ability to repay the obligation.

Contract Guarantees and Primary Mortgage Insurance—The Department collects a contract guarantee fee on all contracts with down payments less than 20%. Such contracts are classified as high loan to value (“HLTV”) contracts. For eligible borrowers, the fee is used to purchase contract guarantees from the U.S. Department of Veterans Affairs (“USDVA”) or primary mortgage insurance. For certain HLTV contracts not eligible for USDVA guarantees, the Fund purchases primary mortgage insurance (“PMI”) from Radian Guaranty Inc., formerly, the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV contracts, not covered by USDVA guarantees, subject to an aggregate 2% deductible. The Department is responsible for any losses not covered by the USDVA guarantees or the PMI.

Other Real Estate Owned—Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

Insurance Claims Payable and Loss Reserves—Insurance claims payable and loss reserves include unpaid claims, incurred but not reported claims and loss reserves for the fire and hazard insurance plan and the remaining benefits payable under the Department’s former self-insured life and disability protection plan.

Fire and Hazard Insurance—This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

Self-Insured Life and Disability Protection Plan—Beginning in 1984, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. This plan was terminated June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were derived from an actuarial evaluation performed in 2001 that is updated internally on an annual basis. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability, prepayment, and a long-term discount rate of 7%.

Amortization of Bond Premiums, Discounts and Issuance Costs—Premiums and discounts arising from the issuance of bonds and expenses incurred in connection with the issuance of bonds are capitalized and amortized using the monthly amortization method, which approximates the interest method.

2. CASH AND INVESTMENTS

Cash in the State Treasury represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer's office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund ("SMIF"), and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law.

The Fund's investment agreements totaling $120,356,000 and $116,253,000 as of June 30, 2006 and 2005, respectively, are carried at cost. The interest rates on investment agreements are fixed and range from 5.30% to 6.46%. The investment agreements expire from 2006 to 2032.

The Fund's investments in the amounts administered by the insurance company are categorized as risk category 1, which is defined by Governmental Accounting Standards Board Statement No. 3 ("GASB Statement No. 3") as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund and the investment agreements are not categorized as to risk.

The Fund's investments at June 30, 2006 and 2005 are as follows (in thousands):

	2006	2005
Category 1		
Amounts held in trust fund with insurance administrators	$ 6,324	$ 6,050
Investments Not Subject to Categorization		
SMIF (at cost)	437,041	526,652
Investment agreements (at cost)	120,356	116,253

4. RECEIVABLES UNDER CONTRACTS OF PURCHASE

The Fund retains title to all real property subject to contracts of purchase until the contract is satisfied. The veteran's contracts have original terms of 25-30 years and bear interest at rates of 4.25% to 9.75%, depending on the age and type of contract and the classification of the contract holder.

5. LAND, IMPROVEMENTS, AND EQUIPMENT

As of June 30, 2006, land, improvements and equipment consisted of the following:

	2006	2005
Land	$ 443,531	$ 443,531
Buildings	12,409,774	12,409,774
Equipment	3,287,545	3,257,564
	16,140,850	16,110,869
Less accumulated depreciation	(14,420,881)	(13,613,428)
Land, improvements, and equipment—net	$ 1,719,969	$ 2,497,441

6. BONDS PAYABLE

At June 30, 2006 and 2005, bonds payable included the following (in thousands):

	2006	2005
General obligation bonds of the State of California, annual interest rates from 4.2% to 11.0% due in varying annual installments through 2037 (subject to varying redemption provisions)	$ 1,279,590	$ 1,356,315
Home purchase revenue bonds, annual interest rates from 2.14% to 6.15%, due in varying annual installments through 2028 (subject to varying redemption provisions)	543,360	569,075
Commercial Paper, due to the State of California, due in full November 2006	56,050	-
Total	1,879,000	1,925,390
Less:		
Discounts	(501)	(540)
Unamortized bond origination costs	(9,392)	(10,253)
Unamortized bond redemption premiums	(629)	(821)
Total	1,868,478	1,913,776
Less—current portion	139,555	79,660
Noncurrent portion	$ 1,728,923	$ 1,834,116

A summary of debt service requirements for the next five years and to maturity is as follows (in thousands):

Fiscal Year Ending June 30	Principal	Interest
2007	$ 83,505	$ 102,230
2008	90,600	94,387
2009	87,430	86,611
2010	68,495	79,431
2011	35,490	74,258
2012-2016	288,210	333,693
2017-2021	410,395	239,718
2022-2026	407,365	141,671
2027-2031	241,155	56,814
2032-2037	110,305	11,238
Total	$1,822,950	$1,220,051

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1996 and 2000 were $485,585,000 at June 30, 2006 and 2005.

Home Purchase Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the $1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 2006 and 2005, authorized and unissued revenue bonds were $956,640,000 and $930,925,000, respectively.

During fiscal year 1998, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to at least three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B and C Bonds, and 2001 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds, and for series 2002 an amount equal to five percent of the outstanding principal amount. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Fund Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 2006 and 2005, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

7. BOND REFUNDING

During fiscal year 2006, the Department did not issue any new or refunding bonds.

In fiscal year 2005**,** the Department issued General Obligation bonds totaling $221,475,000 and Home Purchase Revenue bonds totaling $42,600,000 with an average interest rate of 4.80%. Bond proceeds of $101,465,000 from the General Obligation bond issues were used to refund previously issued General Obligation bonds in the same amount. Bond proceeds of $42,600,000 from the Revenue bond issues were used to refund previously issued Revenue bonds in the same amount. The Department decreased its total debt service payments over the next fifteen years by approximately $24,319,000 and realized an economic gain (difference between the present values of the debt service payment on the old and new debt adjusted by cost of issuance) of approximately $15,776,000 in connection with the refunding.

8. FIRE AND HAZARD INSURANCE

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to $2,500,000 per occurrence or $13,000,000 per policy year. Coverage in excess of the above amounts is provided by several insurance carriers up to an additional $50,000,000. The loss reserve is based on the third party administrator's estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses and change in loss reserves for the year ended June 30, 2006 and 2005, was as follows (in thousands):

	2006	**2005**
Amounts charged to contract holders	$ 7,862	$ 5,992
Less:		
Increase in estimated loss reserve	(749)	(24)
Claims loss expense	(2,954)	(4,734)
Master policy premium	(949)	(565)
Administrative fees	(581)	(460)
Third party contract-replacement value project	(308)	-
Net revenue—Fire and hazard insurance program	$ 2,321	$ 209

9. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. Except for existing contract holders receiving benefits at that date, the self-insured life and disability protection plan was replaced by existing life and disability insurance plans provided by commercial insurers.

As of June 30, 2006, the Department remains self-insured for approximately 325 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 2006 and 2005, was as follows (in thousands):

	2006	2005
Claims expenses:		
Life insurance program	$ 282	$ 336
Disability insurance program	2,693	3,225
Total claims expenses	2,975	3,561
Decrease in estimated loss reserves	(3,600)	(2,600)
Net claims (revenue) expense and change in loss reserves	(625)	961
Plan revenues:		
Life insurance program	(29)	(38)
Disability insurance program	(71)	(82)
Total	(100)	(120)
Administrative fees	30	40
Net (revenue) expense—		
Self-insured life and disability insurance program	$ (695)	$ 881

10. COMMITMENTS AND CONTINGENCIES

As of June 30, 2006 and 2005, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately $124,702,169 and $98,251,372, respectively.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 2006 and 2005, was $371,397 and $361,361, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 2006, minimum annual rentals under operating leases are as follows (in thousands):

2007	$ 111
2008	113
2009	100
2010	47
Total	$ 371

11. RETIREMENT PLAN

Plan Description—The Fund contributes to the Public Employees' Retirement Fund ("PERF") as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System ("CalPERS"). CalPERS provides retirement, death, disability, and post retirement health care benefits to members as established by state statue. CalPERS issues a publicly available Comprehensive Annual Financial Report ("CAFR") that includes financial statements and required supplementary information for the Public Employees' Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the internet at www.calpers.ca.gov.

Funding Policy—Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on 5% of compensation in excess of $513 each month.

Contributions by the Department to the Plan for the years ended June 30, 2006 and 2005 were approximately $1,199,000 and $1,395,000, or approximately 15.3% and 16.3% of participants' salaries, respectively.

Annual Pension Cost—For Department's annual pension cost was equal to the Department's required and actual contributions. Required contribution is determined by actuarial valuation using the entry age normal actuarial cost method. The most recent actuarial valuation available is as of June 30, 2003 which actuarial assumptions included (a) 8.25% investment rate of return compounded annually, (b) projected salary increases that vary based on duration of service, and (c) overall payroll growth factor of 3.75% annually. Both (a) and (b) included an inflation component of 3.5% and a .25 percent per annum productivity increase in consumption. The actuarial value of CalPERS assets attributable to the Department was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a two to five-year period.

Three-Year Trend Information for the Plan—

Three-Year Fund Trend Information

Fiscal Year End	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
June 30, 2004	$ 1,349,000	100%	$ -
June 30, 2005	$ 1,395,000	100%	$ -
June 30, 2006	$ 1,199,000	100%	$ -

The most recent actuarial valuation of CalPERS indicated that there was a deficiency of assets over accrued liabilities for benefits due to active and inactive employees and retirees in the plan. The amount of the under funded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 2005 CalPERS CAFR.

12. TRANSFER FROM DISASTER INDEMNITY FUND

The Disaster Indemnity Fund (“Disaster Fund”), a separate fund of the Department, accounts for coverage provided to contract holders for damage caused by flood, earthquake and other perils. During the year ended June 30, 2006, the Department transferred $2,300,000 from the Disaster Fund to the Fund, which represents the return of the original transfer of monies in 1986 out of the Fund, which were used by the Disaster Fund to mitigate the increased cost of premiums for excess disaster insurance, as well as unusually large losses experienced by the Disaster Fund during 1986.

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